assessing the competitiveness of the market.[25] Yet, in the discussion of market-based access reform, particularly with respect to Phase II, it discusses only one of these, market share, as an indicator of competition.[26]

While market share, along with demand and supply elasticities may be appropriate indicia in antitrust cases, "market share is not only an insufficient indicator of competition, but in regulated industries, it is also irrelevant."[27] Regulation serves to sever market power from market share. Thus "only the appearance and not the reality of monopoly power is created thereby."[28]

No reliable LEC data exists to measure market share. Our own data will be of little or no use to the Commission in determining how much market power we have; our *competitors'* data is needed. What we have on our competitors is the proverbial tip of the iceberg -- the rest is proprietary. The Commission could order our competitors to supply data, such as maps of their principal transmission lines and switching capacity,[29] but our competitors would likely seek confidential treatment of this data, and a FOIA proceeding would have to be concluded before anything could be done with it.

Because user demands are so highly concentrated in telecommunications services, even knowing the full extent of our competitors' networks would not indicate the true degree of competitive pressure on our services. One of the most important forms of competition is self-supply or contract

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[25] *Notice* ¶¶ 156-160.

[26] The Commission's proposed Phase II trigger also includes a discussion of absolute measures of competitors' presence in an area.

[27] Emmerson, p. 12.

[28] William M. Landes and Richard A. Posner, *Market Power in Antitrust Cases*, Harvard Law Review, Vol. 94 (March 1981) pp. 975-976.

[29] *In the Matter of Telecommunications Access Provider Survey*, CCB-IAD 95-110, *Comments of Pacific Bell and Nevada Bell*, filed December 11, 1995.

carriage by large, intensive users, providing direct connections to IXCs using satellite, optical fiber, or microwave, and self-supplying their own services. Competitors abound; competitive factors to be examined must recognize them.

VI. THE COMMISSION SHOULD ENCOURAGE A MARKET-BASED APPROACH TO ACCESS PRICING WHICH BENEFITS CONSUMERS AND ADVANCES COMPETITION; IT WILL NOT GET THESE RESULTS WITH RESTRICTIVE TRIGGERS OR A MAZE OF COMPLEX PRICE CAP RULES WHICH BLOCK OR FRUSTRATE LEC PRICING FLEXIBILITY; MOREOVER, CREATING ARTIFICIAL PRICING DISTINCTIONS FOR LIKE SERVICES (UNBUNDLED ELEMENTS AND ACCESS CHARGES) WILL KILL OFF INVESTMENT VITALLY NEEDED TO ACCOMPLISH FUNDAMENTAL ACT OBJECTIVES (¶¶ 161-217)

A. Summary of Pacific's Proposal for Market-Based Triggers, Price Cap Reform, and the Pricing of Access Charges and Unbundled Elements.

There are three major components to our proposal for access pricing founded on market forces: 1) identifying the appropriate triggers, 2) defining what pricing freedoms should be permitted, and 3) setting the correct relationship between unbundled elements--particularly combined elements that are the functional equivalent of switched access---and access charges. Underlying our proposal are three critical objectives, or tests, that have to be passed for the plan to succeed. First, there has to be sufficient competition to keep access prices at market levels; second, the LECs and their shareowners must be accorded a reasonable opportunity to recover all the costs of telephony; and third, the plan has to encourage investment.

Our proposal begins with a single, realistic trigger -- a demonstration that entry barriers have been eliminated and therefore nothing stands in the way of other facilities-based providers from supplying access services. It is, we concede, a trigger founded on supply elasticity, and one which will (correctly) side-step endless wrangling over market share or demand elasticities. Moreover, this trigger is met when the LEC's state commission has ended all legal barriers to entry and the LEC has entered into interconnection agreements which have been approved by state commissions. When no legal barriers prevent entry, when competitors have actually entered the market, and when traffic is being passed, the ability to increase price above competitive levels has ended.

There is no reason to micro-manage access prices when alternative suppliers are present, but pricing freedom means nothing if its execution is tied to a maze of regulations few, if any, can claim to know or have mastered. The current price-cap structure is a bureaucrat's labyrinth, but it offers no hope of competitive prices reflecting both costs and market conditions. The current structure has to be simplified to allow contract carriage, volume discounts, and reduced number of baskets and bands, and geographically deaveraged prices.

Finally, the FCC should resist all temptations to manipulate the access market by creating an artificial and mandated price differential between unbundled elements and access charges. The *Notice* suggests such a differential could serve as a competitive check on access price increases. It is doubtful, however, whether this purpose would ever be served by such a pricing differential, and it would create other problems. In addition, with the competition we face, it is entirely unnecessary. More importantly, micro-managing the prices of unbundled elements and access charges will undermine the LEC's ability to recover its costs while at the same time discourage the very investment necessary for a healthy telecommunication infrastructure and the development of competitive, alternative providers. When unbundled elements are used to originate or terminate interstate calling, interstate access charges must apply to unbundled elements to prevent destructive arbitrage. Moreover, the application of state access charges must remain within the province of state commissions.

B. Phase I Should Be Triggered By An Approved Interconnection Agreement Or Statement Of Generally Available Terms and Conditions. (¶¶ 168-179)

The Act imposes various duties on LECs. These duties include the section 251 requirements (unbundling, interconnection, number portability, etc.), accounting safeguards, and structural safeguards.[30] Thus, there already exists a system of Congressionally-imposed checks and balances to ensure that the local and access markets embrace competition.

> The key to securing effective competition in access services is overcoming the entry-deterring effect of the substantial sunk cost associated with local exchange facilities. Consequently, the attachment of open access to local networks constitutes the relevant test of competitiveness.[31]

The Commission's effort to insert additional and repetitive checks through the triggering process is unnecessary, unwarranted and does not support a deregulatory framework.

Unbundled loops, switching and transport give entrants easy access to existing customers. Collocation, resale and other obligations also promote entry. "In combination, the Act's open access provisions have significantly reduced or eliminated entry barriers associated with heavy sunk costs."[32] There are few if any places where that is more true than in California where entrenched competitors are wresting customers from us on a daily basis. Therefore, the appropriate trigger for Phase I flexibility should be the removal of entry barriers as indicated by an approved interconnection

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[30] The Commission has issued rules "to prohibit anticompetitive discrimination and cost-shifting, while still giving consumers the benefit of competition" (*Implementation of the Non-Accounting Safeguards of Section 271 and 272 of the Communications Act of 1934*, as amended, CC Docket No. 96-149, *First Report and Order and Further Notice of Proposed Rulemaking,* released December 24, 1996.) and to "protect regulated service ratepayers from bearing the risks and costs of carriers' nonregulated ventures" (*Accounting Safeguards Under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, released December 24, 1996.)

[31] Emmerson, p. 10.

[32] Emmerson, p. 16.

agreement or statement of generally available terms and conditions. Pacific Bell has 18 interconnection agreements with 14 carriers (including 3 CPUC-approved arbitrated agreements with AT&T, MCI, and Sprint).

A separate proceeding should not be necessary to establish that Phase I or Phase II triggers have been met. Instead the Commission should simply require a LEC to show the presence of competition through a state approved interconnection agreement, or through a state approved statement of generally available terms and conditions. That could be accomplished by incorporating the showing into the Description and Justification section of a tariff filing. Parties wishing to object to the tariff on the basis that a trigger has not been met could do so by way of the current process of petitioning to suspend or reject the tariff. Requiring a separate proceeding, as proposed in the *Notice*[33] will simply pave the way for competitors to further delay deployment of beneficial terms, and will increase administrative complexity associated with instituting appropriate reforms.

C. Phase I Relief Permits Pricing Flexibility (¶¶ 168-200)

Once the Phase I trigger has been met for the study area, a carrier will be eligible for the simplified price cap basket structure explained in detail by USTA in its comments,[34] volume and term discounts, contract carriage, and elimination of onerous Part 69 requirements. We agree with USTA that each of these areas is important and will substantially increase access pricing efficiency.

1. Contract Carriage Would Substantially Benefit Customers In Many Access Markets (¶¶ 193-196)

One element of Phase I relief is contract carriage. The Commission proposes that the contract tariff would be required to be made publicly available through a tariff filing setting the

[33] *Notice* ¶ 177.

[34] We do not discuss this reform in these comments. We support the concept as outlined by USTA in its comments.

contract's terms, and making it generally available on same terms and conditions to similarly-situated customers. Once a service is subject to contract carriage, the Commission proposes to remove it from price caps. We strongly support this approach to contract carriage.

Some have criticized contract carriage because they fear that, under the filed rate doctrine, a carrier would have the ability to modify a tariff unilaterally, even over a customer's objection.[35] The filed rate doctrine holds that in cases where both a contract and a tariff govern a carrier's provision of services to a customer, in the event of a conflict between the two, the tariff controls.[36] Some fear that this doctrine, coupled with Section 203 of the Act, permits a carrier to modify the terms of a contract through a unilateral tariff filing.

A close reading of the law indicates that these fears are unfounded. Well-established tariff law severely constrains the ability of a carrier to modify a tariff over the objections of a customer. Since the 1970s, the Commission has recognized that customers entering into long-term service relationships with a carrier are entitled to the benefits of that relationship, absent special circumstances. Thus, tariff revisions that alter material terms and conditions of a long-term contract will be upheld only if the carrier can demonstrate "substantial cause for change."[37] The "substantial cause" doctrine was imported into the contract carriage arena in the *Interexchange Order*.[38] There, the Commission emphasized the fact that tariff provisions were the result of individual negotiation; thus, if a carrier were permitted to alter a contract unilaterally, the benefits of that negotiated agreement would be

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[35] We have attached to these Comments an ex parte dated November 15, 1996 setting forth in detail the legal precedent for contract carriage and why contract carriage is in the public interest.

[36] *See Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 582 (1981); *American Broadcasting Companies, Inc. v. FCC*, 643 F.2d 818 (D.C. Cir. 1980).

[37] *RCA American Communications, Inc.*, 84 FCC 2d 353, 358 (1980).

[38] 10 FCC Rcd at 4572-4574, ¶¶ 23-25.

diminished.[39] The Commission also stressed that, given the substantial competition in the business services market, it was unlikely AT&T would attempt to modify established tariff provisions.[40] All of these principles are grounded in the prohibition of unreasonable practices by carriers in Section 201(b) of the Act.[41]

California has permitted intrastate services to be provided under filed contracts since 1987. Partially competitive and fully competitive services may be offered on terms and conditions different from those in the general tariff for the service. The contracts filed with CPUC disclose the terms of the agreement (prices, service description, volume limitations and term). Commercially sensitive information, including the customer's name, may be kept confidential. The CPUC has recognized that the marketplace and consumers are better off if LECs have contracting flexibility in competitive areas. [42]

We agree with the Commission that for Phase I relief, there will need to be a one-time adjustment of our price cap or service band indices to reflect the reduction in revenues when a contract takes effect. We suggest that in the annual filing, a rate element line be added to each service band

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[39] *Id.*

[40] *Id.*

[41] There is an argument that the prohibition of unreasonable practices in Section 201(b) of the Act cannot be invoked to limit the rights of a carrier to modify a tariff unilaterally. Although this argument seems attractive at first blush, scrutiny reveals that, in practice, it goes too far. It is well-established that tariff revisions by a carrier can be rejected if the Commission finds that any of the proposed terms are patently unlawful. *See Maine Public Advocate v. FCC*, 828 F.2d 68 (1st Cir. 1987). The Commission also can suspend and ultimately prevent a tariff from taking effect based on a finding that a term is unlawful as an unreasonable practice under Section 201(b) of the Act. *See Capital Network Systems, Inc. v. FCC*, 28 F.3d 201 (D.C. Cir. 1994). Thus, while one might argue that the mere unilateral filing by a carrier of a revision to a tariff is permitted under Section 203, the revision can nonetheless be rejected as unlawful and prevented from taking effect. The consequences to the customer are the same under either legal theory.

[42] *In re Alternative Regulatory Frameworks for Local Exchange Carriers*, 1994 Cal. PUC. LEXIS 681.

affected by contracts that took effect during the base demand period. This line will contain the aggregate price reductions in that service band as a result of any contracts. Because of the requirements of the price cap model, the current price will be the aggregate revenues before contracts, and the proposed price will be the aggregate revenues after contracts with a base period demand of one. The base period demand for the rate elements affected by contracts will also be reduced to reflect only the quantity being offered at the tariffed rate and to avoid double-counting the revenues received from those rate elements. Subsequent reductions in contract prices, a likely effect of increased competition, will therefore not result in any increase in "headroom" (*i.e.*, additional upward pricing flexibility) for the affected basket or bands. Under this proposal, we would have no more ability to increase price capped rates than the current rules afford us.

2. New Services Should Not Be Subject To Onerous Requirements Such As Part 69 Waivers Or Public Interest Tests (¶¶197-200)

The *Third Report and Order,* issued concurrently with the *Notice,* purportedly "eliminates the need for obtaining a waiver before an incumbent LEC introduces a new service."[43] In reality, though, the Commission simply substitutes one onerous process for another. In the *Third Report and Order*, the Commission requires that a party seeking to introduce a new service show that the new service is in the public interest. However, in the *Notice*, the Commission asks whether it "should eliminate all requirements that an incumbent LEC obtain any regulatory approval before a tariff introducing a new service can take effect.[44] New services, which offer customers new options and features, should be allowed to go into effect without any regulatory process proving that it is in the public interest, or meets any artificial Part 69 definitions. This has always been the case with special

[43] *Notice* ¶ 199.
[44] *Notice* ¶ 199.

access services. As a result, special access services became the first highly competitive service in LEC territories. If the Commission is committed to a deregulatory market, then the market will determine whether a new service is in the public interest. If it is, customers will buy it; if not, it will not generate any revenue.

The Commission's mandate in the Communications Act is to encourage the introduction of new service and technologies:

> It shall be the policy of the United States to encourage the provisions of new technologies and services to the public. An person or party (other than the Commission) who opposes a new technology or service proposed to be permitted under this Act shall have the burden to demonstrate that such proposal in inconsistent with the public interest.[45]

Contrary to its mandate, continued use of the Part 69 waiver process, or a process that requires new services to be found to be in the public interest, has the effect of discouraging innovation and introduction of new services. Continued regulatory oversight over new services is unnecessary. The Commission should not regulate them prior to introduction, via required waivers or petitions, but also should not subject them to price caps.

We expect most new offerings to be the result of incremental improvements in network functionality. Because we do not manufacture telecommunications equipment, we rarely have access to technology or know-how that is not already on the market. SONET, fast packet switching services (frame relay and SMDS), and ATM switching, for example, are based on new switch functionalities developed by switch manufacturers (*e.g.*, Lucent, Newbridge, and Cisco). For this reason, any theoretical advantage we might have over our competitors is short-lived. By the time a new service is

[45] 47 U.S.C. 157(a).

allowed and a tariff has taken effect, we are rarely the first or only provider; usually, a multitude of service providers offer fully competitive products. These competitors' products usually compete with our existing product line, so lengthy reviews of new service offerings designed to meet competition allow competitors to win our customers. The continued use of Part 69 to mandate rate structures constrains our ability to meet competition and to deploy new services. Therefore, Part 69 should not be applied to new services.

3. Geographic Deaveraging Must Be Authorized To Reflect Variations In Costs (¶¶ 180-186)

Our costs vary geographically. In the federal and state universal service proceedings, and in our arbitration filings at the CPUC, we have submitted data supporting these cost differences. As a result, the CPUC has approved unbundled transport and switching element prices which vary by geography across 4 zones. Similar geographic deaveraging is necessary for access prices because, as the Commission recognizes, "[w]here unbundled network elements are deaveraged, continuing to require access rates to be averaged across the study area would foreclose the incumbent LEC from meeting competition from unbundled network elements in low-cost areas, while still requiring the incumbent LEC to charge below-cost access rates in high cost areas."[46] In the *Local Competition* proceeding, the Commission concluded that "deaveraged rates more closely reflect the actual costs of providing interconnection and unbundled elements."[47] Because the zones that have been established by the CPUC for unbundled elements are cost-based, the same zones should be used for access pricing. In that way, zoned pricing will reflect consistency between services that are functionally equivalent.

46 *Notice* ¶ 182.
47 *Local Competition Order* ¶ 764.

4. Term And Volume Discounts (¶¶ 187-192)

As the Commission has proposed, we support term and volume discounts for all access services. Term and volume discounts promote competition and foster pricing efficiency. The marketplace demands them. Our competitors use them liberally. They are an essential means to drive prices towards economic costs and to keep customers on our network. Term and volume discounts should be nondiscriminatory, and offered to all similarly situated customers. No special showing or cost justification should be required once the Phase I trigger has been met. Antitrust guidelines offer appropriate economic price floors; no additional Commission oversight is necessary.

D. Phase II Should Remove Services From Price Cap Regulation When Competition Is Demonstrated In The Area (¶¶ 201-217)

1. Substantial Competition Should Be Established By Service And On a Geographic Basis. (¶¶ 202-210)

Once CLCs are using the interconnection arrangements negotiated with the ILEC, and unbundled elements or other services have been purchased, and minutes are being exchanged, the ILEC services that compete with the CLC services should be freed from price cap regulation. Because competition for services varies, not only in different parts of the country, but also within a single study area, the competitive showing in Phase II should be on a geographic basis using a wire center or a group of contiguous wire centers. As we explained earlier in Section IV, competition is extremely concentrated. Competitors can serve relatively limited areas and take a substantial amount of our business. We need to be able to meet this competition in these areas. Examining wire centers will provide an appropriate picture of the state of competition in that particular area. For each geographic area, a company will be able to make its competitive showing on the basis of a single service, or group of cross elastic services.

We believe that a competitive showing should be based on availability of alternate providers. The type of information we would provide is as follows:

Summary of Access Competition

Geographic Area	Number of Competitive Fiber Networks	Number of Collocation Cages	Number of Cross-Connects
Wirecenter$_{(1)}$			
Wirecenter$_{(2)}$			
Wirecenter$_{(n)}$			

In addition, we could also supply a status of local competition in the area:

Status of Local Competition

Geographic Area	Local Inter-connection Trunks	Local Usage Exchanged (MOU per mo.)	Number of NXX Codes Opened by CLCs	Services Offered By CLCs		
				CLC local switching (Y/N)	Resale lines in service (Y/N)	Unbundled loops in service (Y/N)
Wirecenter$_{(1)}$						
Wirecenter$_{(2)}$						
Wirecenter$_{(n)}$						

E. <u>The Commission Should Forbear From Regulating DS1 And Higher Special Access Services Since They Face Substantial Competition (¶ 153)</u>

Forbearance is mandatory when regulation is no longer necessary to ensure just and reasonable rates, when regulation is no longer needed to protect consumers, and when forbearance is in the public interest.[48] Special Access and Collocated Direct Trunked Transport (DTT) meet these requirements, as do interexchange and directory assistance, as explained in the USTA comments.

As USTA cites in its Comments, Pacific Bell's market share of provisioned special access service has been reduced to 54.6% in Los Angeles and 53.1% in San Francisco as of the end of the Third Quarter 1996 (Report prepared by Quality Strategies, Washington D.C.). The loss of nearly half the market share in these areas is a clear indication of the competition in this market. Furthermore, in the Quality Strategies Study, we learned that 79.1% of the traffic on DS1 service is switched access traffic. For DS3 service, 56.0% of the traffic is switched access. The results here specifically prove that special access facilities, which are highly cross-elastic for switched traffic, are subject to significant competition; customers are being served very well by the competitive market and there is no need to continue to regulate these services.

As USTA has correctly pointed out, the ILECs should be afforded the opportunity to respond to competition when market conditions exist for several types of services which are now and have been subject to intense competition as described above.

VII. THE FCC SHOULD NOT ADOPT THE PRESCRIPTIVE APPROACH TO ACCESS PRICING (¶¶218-240)

As explained above, the Commission can attain its goal "to foster the development of substantial competition for interstate access services" through a properly implemented market-based approach to access reform.[49] For all of the reasons previously discussed, the access reform policies advocated by Pacific will both realize all of the advantages of a market-based approach identified by

[48] 47 USC 160(a).
[49] *See Notice* ¶ 149.

the Commission as well as address the putative "disadvantages" about which the FCC noted some concern.[50] Pacific's approach will, thereby, obviate any need to combine a market-based approach with elements of a prescriptive approach and, as a result, avoid embroiling the Commission in burdensome regulatory processes that can never hope to replicate the efficiency-enhancing capabilities of marketplace forces.

The Notice seeks comment on the feasibility of adjusting price cap indices downward, or represcribing access rates, to reflect the difference between current rate levels and those which would obtain under a forwarding looking cost methodology such as TSLRIC or TELRIC. The FCC tentatively concludes that some form of such a costing methodology should be employed, and asks parties to address how it might be implemented by the Commission or the states.[51] It also invites comment on a number of alternative adjustments to the price cap rules that could achieve the same end.[52]

The FCC admits that the prescriptive approach to access reform is being advocated principally by IXCs, which are the entities that stand to benefit the most from a flash cut reduction in their access costs and the shifting of those costs to other entities, i.e., the ILECs and the public. Historically, of course, such access charge reductions have not been passed through to end users. Like their advocacy of the confiscatory Hatfield Model, the IXCs' purposes here are transparently obvious and legally suspect, as noted by the Eighth Circuit.[53] The Commission should not be seduced into following their lead.

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[50] *See Notice* ¶ 142
[51] *Notice* ¶¶ 222, 224.
[52] *Notice* ¶¶ 229-235.
[53] See *Notice* ¶¶ 218, 220.

In fact, even apart from the availability of the far better alternative of a market-based approach to access reform, the prescriptive approach to access reform is antithetical to competition, unreasonably burdensome, and will fail to meet the stated goal of efficient pricing. In particular, it will not lead to rational pricing of toll services or meet any other goals of the Act. Rather, IXCs will merely take advantage of the process to pad their already exorbitant toll margins, just as they have in the past.

Moreover, the prescriptive approach discussed by the Commission simply cannot be implemented as either a legal or practical matter. First, a regulatory prescription to reduce access rates to TSLRIC or TELRIC—without establishment of a mechanism to guarantee recovery of ILEC's actual embedded costs—cannot lawfully be adopted absent: (1) separations reform, which the Commission has deferred to a later date,[54] and (2) universal service reform to ensure recovery of mandatory subsidies, which remains pending and requires substantial changes from the Joint Board's recommendations in order to satisfy legal requirements,[55] in order not to run afoul of takings prohibitions. Second, the task of prescribing the level of each access charge element and subelement is one which the Commission has repeatedly declined to undertake in its price cap proceedings,[56] runs counter to the general deregulatory goals of the Act, and would undermine all efficiency incentives inherent in the price cap regime. Accordingly, as set out in detail below, the Commission should reject all elements of a prescriptive approach to access charge reform.

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[54] See *Notice* ¶ 6.

[55] Comments of Pacific Telesis Group, CC Docket No. 96-45 (filed December 19, 1996).

[56] See, e.g., *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, 4 FCC Rcd 6786, 6816 (1990).

A. The FCC May Not Lawfully Implement The Prescriptive Approach To Access Reform Described In The Notice (¶¶218-240)

Common to all of the prescriptive proposals raised in the *Notice* is a Commission-mandated reduction in current access rates quantified on the basis of forward-looking cost principles. This would be the case whether the FCC prescribes new rates itself, directs state commissions to complete the necessary cost studies and prescribe new rates, or reinitializes price cap indices in order to require its desired rate reductions. Nor can the Commission rely on cost proxy models, such as the Hatfield model, to establish access rates. Whatever the merits of individual models for disaggregating loop costs to small units of geography in connection with universal service subsidies, they have no place in setting access prices, because they deemphasize the influence of usage, are based on theoretical cost of idealized networks, not the carriers' actual technology choices and facility mix and, in particular, ignore many prudently incurred costs.[57] Each of these alternatives suffers from the same fatal defects and should be rejected.

1. Access Charges May Not Be Reduced Prior To Separations Reform (¶¶218-240)

In the *Notice* the Commission defers separations reform to a future proceeding.[58] The existing Part 36 separations rules provide, in relevant part, for the allocation of carriers' actual fully distributed costs to the interstate jurisdiction on the basis of direct assignment, where possible, relative use, or a 25% allocator.[59] Nothing the Commission does in this proceeding can change those rules.[60] Rather, pursuant to Section 410 of the Communications Act, 47 U.S.C. §410, a Joint Board must be

[57] Emmerson, pp. 23-24.

[58] *Notice* ¶ 6.

[59] *See*, 47 C.F.R. Part 36. "Costs" are defined in Part 36 as the "cost of property owned by the Telephone Company. . . ." 47 C.F.R. Part 36 (Appendix). This definition cannot be satisfied by reference to the hypothetical, forward-looking costs of some imaginary entity.

[60] *See* 47 U.S.C. § 410(c). *Cf. New York Tel. Co. v. FCC*, 631 F.2d 1059 (2d Cir. 1980).

convened to effect a change in the separations rules. Thus, the amount of costs to be recovered under the access charge regime cannot be reduced in this proceeding.

It is also well established that carriers must be permitted to recover their costs of operation.[61] This would include recovery from the interstate jurisdiction of all costs allocated to that jurisdiction by the separations process. It follows that the FCC lacks the power to prohibit the recovery of the full interstate allocation of separated costs by prescribing access rates—or reinitializing price cap indices—based on some other measure of cost not consistent with the separations rules.[62] Further, because the Part 36 rules, including the definition of costs, may not be modified except by a Joint Board convened pursuant to Section 410 of the Act, the Commission may not in this proceeding prescribe a different measure of cost for the calculation of access rates. Accordingly, if interstate access rates are reduced, the Commission must assure some alternative means of recovery.

2. Proxy Models Should Not Be Used For Pricing

Proxy models should not be used for pricing access services or unbundled elements. In the universal service docket, we have advocated use of a proxy model in order to disaggregate loop costs down to very specific geographic areas in order to estimate costs of service. No cost studies exist with the granularity necessary to estimate wide variations in loop prices across geographies. Thus proxy models provide an essential component for determining proper subsidy distribution. "When estimating costs for pricing purposes, the economically preferred method is to reflect as closely as possible the actual choices faced by engineers in placing relevant facilities."[63] Detailed cost studies,

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[61] *See* 47 U.S.C. § 201.

[62] The shortfall between the allocation of separated costs and a deficient Commission-prescribed access cost recovery based on TSLRIC or TELRIC would also dramatically illustrate the unconstitutionality of such a prescription.

[63] Emmerson, p. 25.

specific to each LEC, must be the basis of pricing decisions, not a model designed to broadly estimate costs of serving particular geographies.

For the following four reasons, proxy models should not be used to price access services or unbundled elements. First, cost studies are being performed all over the country to determine the cost of unbundled network elements and access. The California PUC has completed a TSLRIC cost study of Pacific's services, and is currently evaluating additional cost studies. Second, there is no reason for the same level of geographic deaveraging of access that is required for universal service. Proposed access charge deaveraging is into a handful of zones. Proposed universal service deaveraging is down to a Census Block Group. Third, the currently existing models do not have the data inputs necessary to determine the cost of access with any degree of accuracy. And, fourth, models—which are at best estimates of costs—should not be used to determine the total amount of compensation that is available to a LEC for the provision of its service.

a) Cost Studies Are Already Available To Price Access

Models should not be used as a substitute for individual company geographic specific cost studies. Cost studies are available. The cost studies reviewed by the CPUC utilize company-specific facilities information and actual usage information--holding times, distances, routes--that is not available as inputs to any of the models that have been proposed for universal service cost calculation and for which there is no reasonable surrogate.

b) There Is No Need To Disaggregate Access Prices To Small Geographic Units

There is no regulatory need for the small geographic definition of costs in access reform. The proxy models were originally developed to create a high degree of geographic deaveraging. The cost of residential basic exchange service varies enormously from geography to geography.[64] Pacific has found, for example, that the costs within a single wire center (Chico, California) vary from a low of $24 to a high of $128 per customer per month. Actual cost information at that level of detail is not available. Models were proposed to estimate the cost variations that occur among high cost areas in order to avoid awarding too great a subsidy in one area and too little subsidy in another area. No one has proposed pricing access by these small geographic units. The smallest geographic units currently proposed are a handful of zones. Even if pricing for usage is driven down to the wire center, cost studies are adequate to price access

c) <u>The Existing Models Do Not Contain Adequate Data for Access Pricing</u>

The data inputs of the models do not accurately determine the cost of access and a large number of the unbundled network elements. The proxy models contain vast amounts of geographic data. The costs of providing basic residential service vary in a manner reasonably related to the density, distance, terrain and other characteristics from which relationships can be drawn, data can be assembled and predictions can be made. This is not the case for access services. While estimates of the cost of residential basic exchange service depend upon the geographic distribution of customers, access services vary in cost according to the volume of traffic associated with the facilities. While the cost of the facilities may be predicted by looking at geographic data, the degree of sharing of the facility with other access services can only be arrived at through guesses. The cost of a minute of access or transport depends critically on the aggregation of traffic that is sent over that terrain. There are significant economies of scale in providing access, which is largely assumed to be a declining cost market. Under those conditions, the volume data that cannot even be reasonably approximated by a

[64] Emmerson, p. 23.

model, but can be accurately measured for a cost study, is absolutely critical. The "dependency on the volume of usage is so strong that it overwhelms the effect of geographic influences."[65]

One must know how many minutes are sent over a facility before any reasonable estimate of the cost per unit can be attempted. This data is not contained in any of the models, nor are reasonable surrogates. In residential basic exchange services, for example, one can (and the models do) assume that if a count of households in a geographic area can be obtained, then the number of residential lines can be estimated. Even in a forward looking cost study, the amount of current traffic is the best – indeed the only – reliable estimate of future traffic. None of the models currently proposed have a source for the estimate of traffic.

d) Models Should Only Be Used To Estimate A Subsidy, Not Total Compensation

Model estimates should not be used in lieu of actual costs for the total compensation available to a company for the provision of a service. In the case of universal service, the Joint Board is not calculating the total compensation that will be available to a LEC (CLEC or ILEC) for the provision of universal service. Rather, the Joint Board is determining the appropriate *subsidy* that should be made available—really the amount of subsidy that one customer should pay to the benefit of another.[66] The total compensation for ILECs and CLECs alike will be the sum of the subsidy that the Joint Board determines is appropriate plus the *price* of basic service. Moreover, the estimates of universal service are independent of the company serving the area.[67]

If the subsidy is inadequate in an area, the ILEC or CLEC may seek an increase. The case for access pricing is quite different. In using proxy costs to set prices, the FCC would be

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65 Emmerson, p. 24.
66 *Id.*.
67 *Id.*

determining the total compensation available to an ILEC for the provision of access services. That compensation should not be made on the basis of a model estimate when complete, area-specific, company-specific, facility-specific cost studies are already available. Models, by definition, only produce estimates of costs. These estimates reflect averages of numerous inputs over the entire country. For compensation purposes, it is legally incorrect to restrict the total compensation for a service to an estimate that may or may not cover actual cost of providing that service.

Beyond the proxy model's ability to accurately predict access prices are the incentives to understate costs by the sponsor of the Hatfield model. AT&T and MCI well understand that any errors in setting prices inherently favor entrants over incumbents. Incumbents must continue to provide access to all geographic areas. Entrants can choose where they are financially advantaged to build and where they should buy facilities. If a model creates distortions in the price/cost relationship, entrants are poised to take full advantage of the model errors. They can choose to build in areas (or for customers) where application of the model produces prices that are too high relative to cost and choose to buy in areas (or for customers) where application of the model produces prices that are too low relative to cost. The fact that they can choose on a customer-by-customer basis to buy the facilities on a resale basis or an unbundled/rebundled basis makes that fact an even richer source of financial opportunity for entrants. <u>Since every error</u> in the price/cost relationship <u>favors</u> the entrant, it is easy to see why AT&T and MCI are so willing to use models in lieu of more accurate costs to set prices.

3. <u>Use Of TSLRIC To Reprice Access Services, Reinitialize Price Cap Indices, Or Justify Above-Cap Filings Would Effect Unconstitutional Takings (¶¶223-238)</u>

As demonstrated in the *Local Competition* Proceeding and recognized by the Eighth Circuit, pricing ILEC services and facilities at TSLRIC or even the FCC's version of TELRIC will fail to compensate ILECs adequately for those resources.[68] Indeed, by basing its costing methodologies on a hypothetical network utilizing the most efficient technologies, the FCC would ensure that incumbents will never be able to recover their actual operating costs. This would be true both with respect to reinitializing price cap indices on that basis as well as evaluating filings for above cap relief by that standard.

Yet, it is well settled that, consistent with the Fifth Amendment's prohibition against uncompensated takings, a utility must be permitted revenue recovery sufficient to "maintain its financial integrity, to attract capital, and to compensate its investors for the risk [they have] assumed."[69] In order for rates not to be deemed confiscatory, there must be "enough revenue not only for operating expenses, but also for . . . capital costs," which "includes service on the debt and dividends on the stock."[70] Plainly, there can be no such sufficient return, and rates would necessarily be deemed confiscatory, where a company is prohibited from recovering even its actual capital expenditures. But, that would be the case under any limitation of access recovery to TSLRIC- or TELRIC-defined costs.[71]

B. <u>Practical Implementation Difficulties Will Doom Any Prescriptive Approach (¶¶218-240)</u>

From the very beginning of its price cap proceedings, the Commission was urged to establish the price cap indices on the basis of detailed cost studies in order to prescribe assertedly

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[68] Emmerson, p. 26.

[69] *Duquesne Light Company v. Barasch*, 488 U.S. 299, 310 (1989) (quoting *FTC v. Hope Natural Gas Company*, 320 U.S. 591, 605 (1944)).

[70] *Hope*, 320 U.S. at 603.

[71] The inclusion of an allocation of joint and common costs would not be sufficient to cure the constitutional infirmity of such a prescription.

appropriate initial price levels for individual rate elements.[72] However, numerous carriers, including AT&T, properly pointed out the tremendous practical problems that would be encountered in attempting to engage in such a comprehensive reevaluation of rate levels as well as the enormous burden on regulatory resources that it would occasion.[73] Moreover, it was evident that whatever benefits might be sought under such an approach could much more readily be secured under a properly structured price cap regime, given carrier incentives for greater efficiency. Thus, it is not surprising that the Commission consistently declined to engage in such a repricing or reinitialization.

The FCC will have a very difficult time justifying a contrary decision here.[74] It cannot be disputed that the forward-looking cost studies that would be required to implement the repricing proposals would be massive and complex. The FCC previously, in the *Local Competition* proceeding, delegated such detailed analysis to the states and proposes a similar delegation as an alternative here.[75] But, as evidenced in the ongoing state arbitration proceedings, some states may lack the resources to accomplish the requisite analysis within a reasonable timeframe.[76] Nor can it be expected that a generic cost model can be devised which would permit the extrapolation of costs in one study area from those in another, as illustrated by the demonstrated unreliability of the FCC's proxy rates for interconnection, which were based on data from only a very few study areas.

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[72] *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, 3 FCC Rcd 3195, 3323-3331 (1988); 4 FCC Rcd at 6816.

[73] *Id.*, 3 FCC Rcd at 3323-24.

[74] *Greater Boston Television Corp. v. FCC*, 44 F.2d 841 (D.C. Cir. 1970).

[75] *Notice* ¶ 224.

[76] The California PUC has completed a TSLRIC cost study of Pacific's services, and is currently evaluating additional costs studies. But other states may not have embarked on such analyses.

Accordingly, the practical problems and immense resource commitments required to implement any version of the FCC's repricing or reinitialization proposals pose an insurmountable barrier to adoption of those alternatives.

C. The FCC's Other Proposals For Modification Of The Existing Price Cap Regime Also Should Not Be Adopted (¶¶231-235)

As the FCC acknowledges, various elements of its existing price cap regime are under reexamination in other proceedings.[77] Those proceedings are the appropriate forums for addressing possible adjustments in the price cap rules concerning rate of return or the productivity factor. At a minimum, the record developed therein would not (as least directly) be affected by the FCC's evident intention in this proceeding to circumvent the Eighth Circuit's stay and coerce the implementation of its confiscatory interconnection pricing rules.

In any event, it is self-evident that reinitialization of price cap indices on the bases suggested by the Commission would be counterproductive. Adjusting price cap rates or indices to correspond to the FCC's vision of forward-looking, most efficient technology costs would cause price caps to reflect the most efficient operations theoretically possible, but would never actually be achieved, by any carrier. Thus, incentives for increasing efficiency of carrier operations would not be advanced. Rather, because no carrier could ever achieve the modeled level of efficiency, it will always be worse off by increasing its investment. As a result, the combination of such a reinitialization with the FCC's interconnection pricing requirements would wholly remove any incentive to build, upgrade, or maintain telephone company networks. As a result, the entire rationale underlying price cap regulation would be vitiated. Such a consequence cannot be squared with the public interest.

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[77] *Notice* ¶¶ 228, 233.

Moreover, another fundamental Act objective -- increasing telecommunications investment -- would be completely undermined.

1. <u>In A Competitive Environment, No Productivity ("X") Factor Is Necessary (¶¶ 231-235)</u>

In competitive markets, automatic productivity reductions are simply unnecessary, because competition provides the necessary price discipline. Yet current rules require the X-factor be applied uniformly to competitive and non-competitive services alike. For LECs subject to even a limited amount of competitive entry, the perverse effects of such automatic, compounding productivity reductions are doubly crippling. They reduce rates in highly competitive markets. Yet they also reduce rates in rural markets where costs are high and current prices inadequate to cover geographic specific costs. In these low- (or no-) margin markets they prevent needed rate rebalancing and artificially deter competitive entry.

We are more subject to this whipsawing effect than any other LEC. We have a few highly competitive metropolitan areas, where the number of collocation arrangements far exceeds the number for any other state -- indeed, they comprise not far from half the nation's total. We have 206 collocation cages built in 79 wire centers. These offices account for over 75% of Pacific's traffic. We also have a vast low-density area -- perhaps two-thirds of our wire centers -- from which, as a whole, we derive little or no contribution to total costs. Our California basic service prices are also relatively low, *i.e.*, highly subsidized in low-density areas. All of this leaves us highly reliant on intraLATA toll services to fund our toll costs. IntraLATA toll is now subject to competition and fast being eroded.

When all of this is considered together, automatic price reductions from an artificial productivity factor prohibits us from investing in our network.